

1 UNITED STATES BANKRUPTCY COURT  
2 EASTERN DISTRICT OF WASHINGTON

3 In re: )

4 METROPOLITAN MORTGAGE & )  
5 SECURITIES CO., INC., )

6 Debtor. )

Jointly Administered Under  
No. 04-00757-W11

7 In re: )

8 SUMMIT SECURITIES, INC., )

9 Debtor. )

10 METROPOLITAN INVESTMENT )  
11 SECURITIES, INC., )

12 Debtor. )

No. 04-00756-W1B

13 METROPOLITAN MORTGAGE & )  
14 SECURITIES CO., INC., SUMMIT )  
15 SECURITIES, INC., and BRUCE )  
16 BOYDEN, as Trustee for the )  
Chapter 7 estate of )  
17 METROPOLITAN INVESTMENT )  
SECURITIES, INC., )

18 Plaintiffs, )

19 vs. )

20 KEITH CAUVEL and MARJORIE )  
21 CAUVEL, husband and wife, )  
et al., )

22 Defendants. )

Adversary No. A04-00061-W11

**FILED**

JUN 20 2005

T.S. MCGREGOR, CLERK  
U.S. BANKRUPTCY COURT  
EASTERN DISTRICT OF WASHINGTON

MEMORANDUM DECISION RE:  
PLAINTIFFS' AND INTERVENING  
PLAINTIFFS' MOTION FOR  
PRELIMINARY INJUNCTION

23 PATRICIA C. WILLIAMS, Bankruptcy Judge:

24 This controversy arises out of two conflicting legal  
25 philosophies; one found in insurance law and one found in  
26 bankruptcy law. When multiple claims exist against an insurance  
27 policy, the distribution scheme is based upon a race with the  
28 fleetest claimant winning the policy proceeds. When multiple

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1 claims in bankruptcy exist against an insolvent debtor, the  
2 distribution scheme is based upon equitable distribution. When the  
3 asset to be distributed is insurance proceeds arising from an  
4 insurance policy held by the debtor, those very different  
5 philosophies may be in conflict.

6 **FACTS**

7 This controversy involves three debtors; the combined  
8 Chapter 11 proceedings of Summit Securities, Inc. and Metropolitan  
9 Mortgage & Securities Co., Inc., and the Chapter 7 proceeding of  
10 Metropolitan Investment Securities, Inc. There are four insurance  
11 policies at issue. Two of these policies are referred to as the  
12 D&O policies and two of these policies are referred to as the E&O  
13 policies. The D&O policies are the National Union policy with  
14 limits of \$10,000,000 and the excess St. Paul Mercury Insurance  
15 policy with limits of \$5,000,000. The E&O policies relate to  
16 broker members of the National Association of Securities Dealers  
17 (hereinafter referred to as "NASD") who dealt with securities  
18 issued by the debtors. The E&O policies regarding the NASD brokers  
19 are the AIG policy with limits of \$10,000,000 and the excess Chubb  
20 policy for \$2,000,000.

21 Simplistically, the debtors and their affiliates and  
22 subsidiaries are named insureds under all the policies. The D&O  
23 policies insure payment of claims against the debtors and their  
24 affiliates, payment of claims made against the debtors' respective  
25 directors and officers, and payment to the debtors for any  
26 indemnification claims which may be made against them by their  
27 directors and officers. The debtors as named insureds also have  
28 the right to seek payment of certain types of claims, such as loss

1 caused by negligent acts of officers. Again, very simplistically,  
2 the same is true of the E&O policies which also include the NASD  
3 brokers as insureds. There are several lawsuits pending in various  
4 state and federal courts on behalf of hundreds of plaintiffs  
5 against the directors and officers alleging violations of  
6 securities law, fraud and similar wrongful acts. There are five  
7 lawsuits pending against various directors and officers and  
8 affiliates alleging wrongful conduct as to certain employees of the  
9 debtors. There are dozens of lawsuits and NASD arbitration  
10 proceedings pending on behalf of hundreds of plaintiffs against  
11 dozens of NASD brokers associated with the debtors which allege  
12 violation of securities law and similar wrongful acts. Additional  
13 claims are known to exist for which no litigation or arbitration  
14 has yet been commenced.

15 Under the terms of the policies, the directors and officers  
16 and NASD brokers and other insured defendants are entitled to have  
17 their costs of defense paid by the insurance carriers from the  
18 policy limits. The policies are commonly referred to as "wasting  
19 policies" or "burning candle policies," meaning that as the  
20 litigation continues, the amount available to a successful  
21 plaintiff under the policy is being reduced by the costs of defense  
22 of the litigation. Because of the number of lawsuits and  
23 arbitrations and the number of third-parties seeking recovery, it  
24 is quite likely that the limits of these policies will be exhausted  
25 before the majority of the claims are fully litigated. Earlier in  
26 the bankruptcy cases, a motion to lift stay was filed requesting  
27 that policy proceeds be distributed to reimburse the costs incurred  
28 by certain non-debtor co-insureds in defending against third-party

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1 claims. The question of applicability of the automatic stay was  
2 reserved for determination in this adversary proceeding. With  
3 Court permission, a procedure was developed whereby defendants'  
4 counsel circulate and file with the Bankruptcy Court requests for  
5 reimbursement under the policies before submitting the same to the  
6 insurance carriers for payment. When last reviewed, the filings  
7 indicated that in the course of about 14 months nearly \$2,300,000  
8 has been sought as costs of defense. The amount currently  
9 reflected by the pleadings is relatively low as an agreement was  
10 reached among the Creditors' Committees in the Chapter 11s, the  
11 Chapter 7 Trustee and the defendants' counsel and most of the  
12 third-party claimants to "stand still" in the pending litigation  
13 and arbitrations.

14 The debtors filed this action seeking an injunction to stay  
15 all litigation and arbitration on March 22, 2004. As the  
16 litigation and arbitration proceedings proliferated, so has the  
17 number of parties to the adversary proceeding. Objections to the  
18 granting of injunctive relief were filed at various times by  
19 various claimants, but since many claimants then agreed to the  
20 "stand still," the request for injunctive relief was not noted for  
21 hearing until March 8, 2005. At that time, various counsel for  
22 various claimants indicated that they had initially objected to the  
23 preliminary injunction but had withdrawn their objections as they  
24 had become persuaded that it was in their clients' best interest to  
25 pursue the possibility of a "global settlement" before policy  
26 limits were significantly reduced or exhausted by the costs of  
27 defending the numerous claims and payment of the first claims ripe  
28 for resolution.

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1       The efforts of the parties during the past several months have  
2 been primarily directed at negotiating a so-called global  
3 settlement which would require the insurance carriers to pay the  
4 policy limits with various groups of claimants sharing in the  
5 policy proceeds on a negotiated basis. At the time of the first  
6 hearing for preliminary injunction in March of 2005, counsel for  
7 debtors reported, and some claimants' counsel confirmed, that  
8 significant progress had been made in negotiating a global  
9 settlement and they were cautiously optimistic a settlement would  
10 result, although not all claimants had participated in the process.

11       The March hearing resulted in the imposition of a preliminary  
12 injunction scheduled to expire on June 7, 2005. All litigation by  
13 third-party claimants against the named insureds under the D&O and  
14 E&O policies was enjoined as well as litigation among the named  
15 insureds. The question of the applicability of the automatic stay  
16 was not addressed due to the imposition of the preliminary  
17 injunction. Upon expiration of the preliminary injunction on  
18 June 7, 2005, another hearing was held to consider the debtors'  
19 position that the automatic stay precludes the prosecution of  
20 claims against the policy proceeds and to determine if the  
21 circumstances regarding a global settlement had changed. As of  
22 that hearing, it was apparent that no global settlement would  
23 occur.

24       The pending request of the debtors is a determination that the  
25 proceeds of the insurance policies are property of the estate and  
26 that the suits and arbitration proceedings are stayed under  
27 11 U.S.C. § 362(a). If the automatic stay is inapplicable, the  
28 debtors alternatively argue the preliminary injunction entered on

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1 March 29, 2005 should be extended. The insurance carriers have  
2 indicated that an interpleader will be commenced and policy  
3 proceeds paid into the registry of the Court. There may be some  
4 issues regarding policy coverage for particular types of claims or  
5 for specific claims, but the total pending claims are approximately  
6 \$600,000,000. Those claims for which no coverage issues exist far  
7 exceed the total policy limits. To date, no such interpleader has  
8 been filed.

9 Metropolitan Mortgage and Summit have filed a joint  
10 liquidating plan. The plan, as proposed, establishes a liquidation  
11 trust. The liquidation trustee would be appointed to pursue some  
12 unrelated suits on behalf of the debtors as well as the debtors'  
13 claims under these policies, i.e., claims the estates may directly  
14 hold against the directors and officers and other insureds as well  
15 as claims against the policies for the costs of indemnifying  
16 directors and officers, brokers and other insureds. The three  
17 debtors also hold claims for reimbursement from the proceeds for  
18 expenses actually incurred by the estates for responding to the  
19 investigations by various securities law agencies and for costs  
20 incurred due to unrelated officer negligence. Those claims for  
21 reimbursement of out-of-pocket costs total approximately  
22 \$3,400,000. Arguably, the policy proceeds would be available to  
23 pay claims held by the debtors thus resulting in additional funds  
24 to pay all creditors.

25 ISSUE

26 Are the policy proceeds property of the estate?  
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16 The applicability of § 541 to proceeds of insurance policies  
17 is not yet a settled question in the Ninth Circuit. It has been  
18 determined that insurance policies are property of the estate. In  
19 *In re Minoco Group of Companies, Ltd.*, 799 F.2d 517 (9<sup>th</sup> Cir. 1986),  
20 the court held that D&O insurance policies were property of the  
21 estate. The court reasoned that since the estate was worth more  
22 with the policies than without them, they constituted property of  
23 the estate. The policies insured the debtor for any indemnity  
24 claims against it by its directors and officers as well as insuring  
25 the directors and officers against third-party claims. The court  
26 concluded that the all-inclusive purpose of § 541(a) required all  
27 interests of the debtor in property, even interests which were  
28 contingent or not yet realized, to become subject to the

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1 reorganization process.

2 In 1990, in *In re Circle K Corp.*, 121 B.R. 257 (Bankr. D.  
3 Ariz. 1990), the court, relying on *Minoco*, held that D&O insurance  
4 policies and proceeds were property of the estate. The court  
5 reasoned that since the policies at issue were indemnity policies  
6 and not just liability policies, the debtor had a right to the  
7 proceeds. Consistent with *Minoco*, the estate was worth more with  
8 the policies and proceeds than without them. Those policies were  
9 also "wasting" or "burning candle" policies. As the defense costs  
10 exhaust the policy limits, the estate asset was depleted which  
11 increased the debtor's exposure to third-party claims and decreased  
12 realization of the debtor's claims against the proceeds. Thus, the  
13 court concluded that the debtor had an interest in the proceeds  
14 rendering the proceeds property of the estate as defined in  
15 11 U.S.C. § 541.

16 In 1997, the Bankruptcy Appellate Panel, in *In re Spaulding*  
17 *Composites Co., Inc.*, 207 B.R. 899 (B.A.P. 9<sup>th</sup> Cir. 1997), concluded  
18 that certain insurance policies themselves were property of the  
19 estate but that the proceeds were not. The insurance company had  
20 brought a state court declaratory judgment action seeking to  
21 determine rights of non-debtor co-insureds in the policy proceeds.  
22 The precise issue presented was whether that declaratory judgment  
23 action violated the automatic stay as the debtor was also an  
24 insured under the policy. The conclusion was that the commencement  
25 of the state court action did not violate the stay. That  
26 conclusion was based not only upon the fact the debtor was not  
27 named in the declaratory judgment action, but also upon the failure  
28 to demonstrate that the insurance company's payment of claims

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1 brought by the non-debtor insureds would impair the insurance  
2 company's ability to satisfy its obligations to the debtor under  
3 the policy. In the present controversy, the evidence is  
4 overwhelming that satisfaction of the insurance companies' duty to  
5 pay claims brought against non-debtor co-insureds, including  
6 satisfaction of the defense costs being incurred by the co-  
7 insureds, will render it impossible to satisfy the claims against  
8 the proceeds held by the debtors.

9 It is the general rule that the automatic stay of § 362(a)(1)  
10 and (a)(3) is available only to debtors and not to third-party  
11 defendants or co-defendants. This general principle has been  
12 extended by some courts to situations where a potential judgment  
13 against the individual insured under a D&O policy may effectively  
14 be a judgment against the debtor due to existing indemnification  
15 provisions contained within the policies. See *A.H. Robins Co.,*  
16 *Inc. v. Piccinin*, 788 F.2d 994, cert. denied, 479 U.S. 876 (1986);  
17 *In re Eagle-Picher Industries, Inc.*, 963 F.2d 855 (6<sup>th</sup> Cir. 1992).  
18 Similarly, certain courts have extended the protection of the  
19 automatic stay in circumstances where collection actions against  
20 non-debtor parties creates an "identity of interests" with the  
21 debtor such that a judgment against non-debtor defendants becomes  
22 in effect, a claim against the debtor for indemnification. *In re*  
23 *Family Health Services, Inc.*, 105 B.R. 937 (Bankr. C.D. Cal. 1989).  
24 See also, *A.H. Robbins Co., supra*. Finally, § 362(a)(3) has been  
25 used to stay actions against a debtor's partners to prevent parties  
26 from proceeding in an action that indirectly affects the debtor's  
27 property interest or attempts to obtain possession of property of  
28 the estate. *In re Bialac*, 712 F.2d 426 (9<sup>th</sup> Cir. 1983). That

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1 decision involved a debtor's undivided one-sixth interest in a  
2 promissory note. The analysis focused on the debtor's right to  
3 redeem the note after the creditor foreclosed on the five-sixth  
4 interest in the note held by non-debtors. The conclusion was that  
5 the right to redeem, although intangible and of unknown value,  
6 constituted property of the estate.

7 The debtors, their affiliates, subsidiaries, officers and  
8 directors and the NASD brokers are named insureds under the  
9 policies. As such, each has the right to utilize the policy  
10 proceeds to satisfy claims by third-party claimants. The debtors  
11 also have the right to utilize the policy proceeds to satisfy  
12 claims the debtors may have against co-insureds and to satisfy  
13 requests for indemnification made by the directors and officers.  
14 The debtors also have a non-derivative right to receive proceeds to  
15 compensate for the costs of responding to certain investigations by  
16 regulatory agencies. Realization of the debtors' legal interests  
17 is contingent upon the debtors meeting conditions established by  
18 the policy for the bringing of claims and those legal interests are  
19 not yet in the form of monetary recovery. However, § 541 renders  
20 a legal interest in property, property of the estate, and does not  
21 require that legal interest to be reduced to a monetary amount nor  
22 to be absolute and non-contingent.

### 23 CONCLUSION

24 Lacking controlling precedent on the issue of whether or not  
25 the policies and proceeds at issue in this case are property of the  
26 estate, this Court is inclined to follow the analysis found in *In*  
27 *re Circle K Corp.* It is this Court's opinion that not only are the  
28 insurance policies property of the estate, but that the proceeds

1 are also property of the estate because the estate is worth more  
2 with them than without them and because the debtors hold claims  
3 payable from the proceeds.

4 The debtors and all other insureds have undivided,  
5 unliquidated interests in the identical asset, i.e., the policy  
6 proceeds. Continued diminution of those proceeds affects the  
7 debtors' interests in and rights to recover the proceeds. The stay  
8 prevents any action which affects the debtors' interests in the  
9 proceeds. This is consistent with and necessary to promote the  
10 fundamental bankruptcy principles of preserving estate property and  
11 ensuring ratable distribution to creditors.

12 Under principles of insurance law, all entities or persons  
13 having an interest in the policy proceeds would engage in a race to  
14 judgment or settlement with the fleetest claimants realizing upon  
15 their interest while the slower claimants were deprived of their  
16 interest. Such a result is contrary to the fundamental principle  
17 of bankruptcy law that all of the debtors' interests in property  
18 are to be equitably distributed. The problem is worsened in this  
19 case by the fact that the cost of determining each claimant's  
20 interest in the policy proceeds may deplete the proceeds before all  
21 but the very fleetest claimants recover.

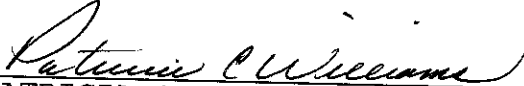
22 Therefore, this Court concludes that the debtors hold legal  
23 interests in the insurance proceeds of the four policies described  
24 above which interests are of value to the estate. The proceeds are  
25 property of the debtors' estates and are subject to the protections  
26 afforded by 11 U.S.C. §§ 362(a)(3). This renders it unnecessary to  
27 address the alternative argument that if the proceeds are not  
28 property of the estate and the automatic stay is therefore

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1 inapplicable, an injunction should be entered to stay prosecution  
2 of the various claims against the proceeds.

3 Finally, there is a fifth insurance policy also at issue. It  
4 is a policy issued by Arch Insurance Company which provides  
5 coverage to approximately five NASD brokers who are specifically  
6 named as insureds under that policy. The amount of coverage is in  
7 dispute as the insurance company maintains that coverage is limited  
8 to a maximum of \$2 million whereas the NASD brokers maintain the  
9 coverage is for a maximum of \$2 million for each insured. None of  
10 the debtors, their affiliates or subsidiaries are named insured  
11 under the Arch policy. None of the debtors have any right or claim  
12 to any of the policy proceeds. The debtors hold no legal interest  
13 in the proceeds of the Arch policy. Consequently, the Arch policy  
14 does not constitute property of the estate.<sup>1</sup>

15 DATED this 20<sup>th</sup> day of June, 2005.

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18 PATRICIA C. WILLIAMS  
19 Bankruptcy Judge  
20  
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22 <sup>1</sup>The five NASD brokers insured under the ARCH policy are among  
23 the dozens of NASD brokers covered by the other E&O policies. The  
24 Arch policy imposes a duty to defend on the insurance company but  
25 it is not a "wasting" or "burning candle" policy as the costs of  
26 defense do not reduce the proceeds available to pay claims. The  
27 evidence indicates that Arch maintains that half of the costs of  
28 defense incurred under the Arch policy should be paid from the  
proceeds of the other E&O policies which constitute property of the  
estate. This opinion does not address that issue. Distribution of  
the E&O policy proceeds, for payment of claims or costs of defense  
or for any reason, must await later determination.

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